

CONTRACTING FIRM'S FAILURE AND FINANCIAL RELATED FACTORS.

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Abstract

This paper is discussing about the role of the financial management in influencing the success of the constructing firms in the construction industry. Based on the previous studies on the impact of financial factors to the failure of the construction projects, bad financial management and lack of capital are identified to be the main determinants of the construction failure (Kangari,1998 & Noven,1996). Since 1988 the construction industry has experienced a higher-than-average business failure rate when compared to the failure rate of all other businesses (Dun & Bradstreet 2002). Large or small, old or new, domestic or foreign construction companies; they are among the statistics of failed construction companies. What are the causes of failure for the construction companies? Why construction projects could not be completed within the original schedule? Why there are so few listed successful contractors? This article provides the actual example of contractor's failure in the construction industry world wide.

Keywords: Construction Industry, construction firm, Financial Management and financial failure.

INTRODUCTION

Either large or small, old or new, domestic or foreign; construction companies are in the high probability of failure. What are the possible causes of failure for construction companies? According to Peterson (2005), it has been proven by the Surety Information Office (SIO) - an office that collects data on surety bonds in United State; the main failure factors are directly related to the financial management of the company. SIO has

identified six broad warning signs to show that a construction company is in trouble. These are:

1. Ineffective financial management system.
2. Bank line of credit constantly borrowed to the limit.
3. Poor estimating and/or job cost reporting.
4. Poor project management.
5. No comprehensive business plan and
6. Communication problems.

Four of the above six sources of failure are directly related to the financial management of the company. In fact, few previous studies that look into the impact of financial factors to the failure of the constructions firms identified that bad financial management and lack of capital are the main determinants of the construction failure (Kangari,1998 and Noven, 1996). Thus, without sound financial management, construction companies are setting themselves up for failure.

Yin (2006), found that, most of the contractors do not have sufficient capital to finance their undertakings. Contractors generally do not have fixed asset like most of the manufactures. They usually do not have land or building but instead, they have construction equipment. Unfortunately, banks do not accept these moving assets as collateral for a loan. Without bank financing, contractors would obviously facing difficulties in undertaking their projects. Financial problems faced by the contractor are also due to the low profit margin gained from the project. Through open tender system which practiced by most of the government and private agencies, contractors always have to produce good work at the cheapest price. Although the system is the best way to ensure completion of any project at the lowest price, but it is the most hurdle obstacle that any contractor has to face in the real competitive world.

Looking at the significant important of financial management in construction industry, the objective of this paper is to review the important of sound financial management practices for construction firms.

PROBLEM STATEMENT

The below examples show the high number of business failure in the construction industry world wide.

According to Dun & Bradstreet, the construction industry in the United State has an experienced a higher-than- average business failure rate when compared to the failure rate of all others businesses. In 1997, a total of 10,867 construction companies in the United State failed, bringing the total for the eight year period beginning in 1990 to more

than 80,000 construction companies (Dun & Bradstreet, 2003). Furthermore, data shows that

the numbers of construction companies doing business in the United States has also declined from 709,590 in 2000 to 698,898 in 2001, resulting in a net decline of 10,692 companies (U.S, Census Bureau, CBP United States Economic Profiles, 2000 and 2001).

Probability of failure is not only faced by small and new firms but it also happens to large contracting firms. For example, in 2002, two of the Japan's – largest construction companies – Sato Kogy Company and Nissan Construction has been filed for bankruptcy (The New York Times, ,2002). Also in the same year, Germany's second largest construction company, i.e, Philipp Holzmann , Which had been in business for longer than 150 years, also has been filed for bankruptcy (The New York Times, 2002)

The same scenario also happens in Malaysia. The failure rate of the construction firms in Malaysia is also high. According to Construction Industry Development Board Malaysia (CIDB), statistics from January 2006 to August 2008 shows a total of 11,321 construction firms has been classified under dormant and non-Active. Figure 1.1, shows the breakdown of the dormant and non-active construction firms by grades. There are seven grades of registration for local construction firms depending on their experience, financial status and personal capability.

Figure 1.1: Statistics for the Dormant and Non-Active Construction Firm in Malaysia (January 2006 – August 2008) by Category/ Size.

State	Category / Size							Total
	G1	G2	G3	G4	G5	G6	G7	
Johor	614	197	230	31	36	8	16	1,132
Kedah	415	78	99	18	32	13	19	674
Kelantan	600	75	134	26	54	15	37	941
Labuan	25	3	5	1	1	0	1	36
Melaka	193	49	61	7	11	6	10	337
Negeri Sembilan	541	85	88	10	7	5	7	743
Pahang	301	66	91	26	14	3	10	511
Perak	455	138	149	23	36	11	16	828
Perlis	172	25	19	6	6	2	5	235
Pulau pinang	280	98	113	12	19	4	23	549
Sabah	662	155	185	33	45	15	43	1,138
Serawak	204	60	62	24	16	5	30	401
Selangor	895	259	404	68	90	35	94	1845
Terengganu	155	37	103	27	32	7	22	383
Wilayah Persekutuan	417	204	462	78	159	53	195	1568
Total	5929	1,529	2,205	390	558	182	528	11,321

Source : Construction Industry Development Board Malaysia/ CIDB (August 2008)

Figure 1.2 shows the category of the local construction firms by grades and paid-up capital with CIDB. CIDB was established in December 1994 and it became the main regulatory agency for the construction industry and undertook the task of registering contractors. Since July 1995, it has been mandatory for all local and foreign contractors to register with CIDB before undertaking construction works in Malaysia.

Figure 1.2 : Registration requisites for local construction firms (CIDB).

Registration Grade	Minimum Paid-Capital (RM)	Limits of Project Size (RM)
G1	5,000.00	Not more than 100,000.00
G2	25,000.00	Not more than 500,000.00
G3	50,000.00	Not more than 1,000,000.00
G4	150,000.00	Not more than 3,000,000.00
G5	250,000.00	Not more than 5,000,000.00
G6	500,000.00	Not more than 10,000,000.00
G7	750,000.00	No Limit

Data Source: Malaysia Construction Industry Development Board 2008

In relation to that, statistics from Contractor's Service Centre (CSC) in 2008, a total of 108 bumiputera contracting firms from the variety of sizes had been blacklisted by CSC (www.pkk.gov.my). The status of 'Bumiputera Contractors' are referring to a contractors which are locally incorporated construction firms with a minimum of 51 percent bumiputera's equity. CSC was established in 1981 to centralize the registration of contractors for government projects. **Figure 1.4** shows the statistics of blacklisted bumiputera contractors by CSC for the year 2001-2005.

Figure 1.4: Statistics of blacklisted bumiputera contractors by CSC,2001-2005

Year	Suspended the Registration	Not Allowed to Participate Government's Project	Total
2001	78	9	87
2002	55	20	75

2003	65	12	77
2004	124	13	137
2005	120	9	129
Total	442	63	505

Source :Contractor's Service Centre (www.pkk.gov.my).

The main reason for the above failure could be explained due to the bad performance of the construction firms. The bankruptcy problems reflect the inability of many construction firms to deliver their project to the client within the stipulated time. According to Basir (2000), in his research on the factors influencing construction delays, he found that most of the construction projects in Malaysia can be characterized by over-run in terms of cost and time. Yin (2006) also observed that, there are so few listed successful contractors in Malaysia and there are relatively more bankruptcies happen in the contracting industry than in any other industry.

2. Non-performing Loan (NPL) in construction industry.

It is also observed that many loans has been given to the construction firms become non-performing, which is commonly referred to un-collectable (Lin,2007). figure 1.5 shows the amount of loans and non-performing loans (NPLs) by contractors for the year 2004 and 2005. The total amount of NPLs at the financial year of 2005 showed an increasing trend from RM 2,703,285,000.00 in 2004 to RM 4,681,328,000.00, where it shown an increment by 73.17 %. For all the commercial banks, most of the NPLs are around 8% to 30% of the total loans, except for Affin Bank Berhad and AmBank (M) Berhad. For these banks, their NPLs were as high as 37% to 54% for 2004 and 2005, compared to the other commercial banks. Public Bank recorded the lowest NPL in year 2004 while United Overseas Bank (Malaysia) Berhad shows the lowest NPL for year 2005. For both Public Bank and United Overseas Bank (Malaysia) Berhad, their NPLs varied from 1% to 6%. This could be due to their prudence when lending to the construction industry unlike Affin Bank Berhad and AmBank (M) Berhad. These banks are popular in giving loans to the contractors. According to Nihon (2001), the increase in NPLs can also be justified is due to the increase in bankruptcy.

Statistics for the year 2001 show that, in Malaysia, the majority of the bankruptcies are contracting firms (Jaafar, 2003) and the number of bankruptcies are increasing yearly (Insolvency Department, 2006). In Malaysia, the current scenario in contractor registration leads to stiff competition and over-capacity. With low value-added activities in the construction industry, the number of bankruptcies of contracting firms is bound to increase.

Figure 1.5. Amount NPLs to bank by construction industry for 2004 and 2005

Commercial Bank	2004			2005		
	Loan (RM'000)	NPLs (RM'000)	%	Loan (RM'000)	NPLs (RM'000)	%
Domestic						
Affin Bank Bhd	1,388,195	638,351	45.98	1,539,131	578,487	37.58
Alliance Bank Bhd	832,016	n/a	n/a	923,763	126,880	13.73
AmBank(M) Bhd	845,141	n/a	n/a	1,551,835	834,620	53.78
BCB Bank	3,837,234	337,018	8.78	4,531,916	478,991	10.57
Eon Bank Bhd	2,064,816	222,860	10.79	1,782,588	250,672	14.06
Hong Leong Bank Bhd	630,179	n/a	n/a	901,480	264,969	29.39
MayBank Bhd	5,437,549	n/a	n/a	5,950,597	822,449	13.82
Public Bank Bhd	1,867,005	90,226	4.83	2,039,666	52,165	2.57
RHB Bank Bhd	2,969,380	676,074	22.77	2,435,838	633,919	26.02
Southern Bank Bhd	1,072,768	76,535	7.13	1,112,725	95,500	8.58
Bank Islam (M) Bhd	904,120	332,455	36.77	1,055,851	335,276	31.75
Bank Muamalat (M) Bhd	510,755	52,383	10.26	533,616	35,242	6.60
Foreign						
HSBC Bank(M)Bhd	457,594	57,149	12.49	428,685	31,718	7.4
OCBC Bank (M)Bhd	909,047	143,305	15.76	896,770	114,670	12.78
Standard Chartered Bank(M)Bhd	86,128	22,416	26.02	122,164	13,881	11.36
United Overseas Bank(M)Bhd	886,927	54,513	6.15	779,883	11,889	1.52
TOTAL	24,698,854	2,703,285		26,586,508	4,681,328	

Source : project financing for small and medium contracting firms.

(Lin,2007)

3. Malaysian contractors and debt capital.

According to Jaafar (2004), only small capital is required to start a construction firm in Malaysia, compared to others businesses, because :-

1. Suppliers are important creditors for construction firms.
2. Sub-contractors also give capital support and are only being paid when contractors get payment from clients.
3. For government projects, contractors may obtain an advance of 25% of the total project price.
4. It is easy to obtain project financing from banks for government projects.

Findings by Jaafar (2004), has proven empirically that, most of the contractors in Malaysia are highly dependent on out sourced capital. This study has provided a support of the McMahon (2001), where he found that business growth outcomes and better business performance are greater dependence upon external finance. By using more out sourced capital such as banking and trade creditor facilities (known as high cost capital), the profit margin of the projects will definitely decrease .

It has been observed from the total amount disbursed to the construction industry (see figure 1.6). It clearly shows that the construction industry is highly dependent on the banks in order to survive (Lin, 2007). Figure 1.6, shows a total amount of financing to construction industry (2001-2005) . In 2005, the total amount of loans to the construction industry was RM 25.26 billion compared to RM 23.29 billion and RM 21.71 billion in 2004 and 2003 respectively. The total loan given to the construction sector decreased for the first 3 years from 2001 to 2003. But this trend reversed towards the end of 2005.

The uncertain trend in amount of loan disbursed to the construction industry is believed to have connection with overall demand in construction industry. For example, if there is a demand for a project in construction industry, it will automatically increase the number of customers applying loan from bank.

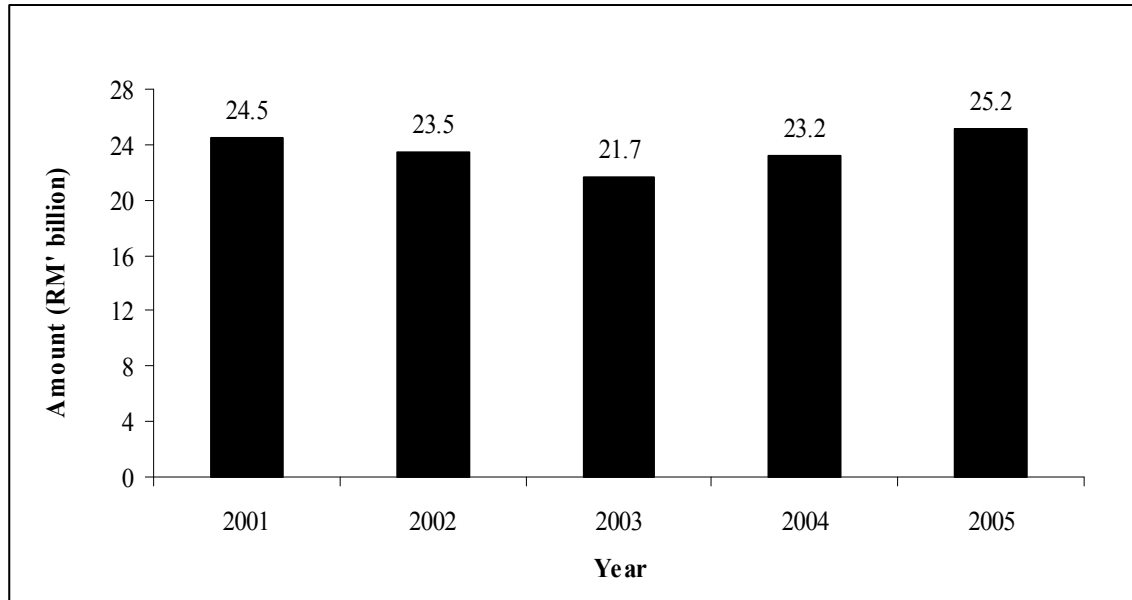


Figure 1.6 Total amount of financing to construction industry (2001-2005) by 14 commercial banks

Source: Yearly Annual Report, 2001 -2005

CONCLUSION

The above scenario clearly shows that financial factors play a crucial role to determine the success or failure of the contracting firm in the construction industry. In general, good financial management skills can help to enhance the firm's performance. Without sound financial management, construction companies are setting themselves up for failure.

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